

ST 98-3

Tax Type: SALES TAX

Issue: Unreported/Underreported Receipts (Fraud)

**STATE OF ILLINOIS
DEPARTMENT OF REVENUE
OFFICE OF ADMINISTRATIVE HEARINGS
CHICAGO, ILLINOIS**

**THE DEPARTMENT OF REVENUE
OF THE STATE OF ILLINOIS**

v.

**XYZ CORPORATION,
Taxpayer**

**No.
IBT:
NTL:**

**Charles E. McClellan
Administrative Law Judge**

RECOMMENDATION FOR DISPOSITION

Alan Osheff for the Department of Revenue. Matthew F. Kennelly of Cotsirilos, Stephenson, Tighe & Streicker, Ltd., for the Taxpayer.

Synopsis:

This matter involves two Notices of Tax Liability ("NTLs") issued to XYZ CORPORATION, ("taxpayer"), by the Department on December 24, 1994, for the period of January 1, 1991, through December 31, 1993. A pre-trial order was entered on February 6, 1997, setting forth the issues as agreed to by the parties, as follows:

1. Whether the Department auditor applied the correct high/low percentage to items sold by the taxpayer.
2. Whether the auditor improperly disallowed certain deductions taken by the taxpayer.

A third issue arose at the hearing, to which there was no objection, when it was noted in the record that there is a discrepancy between the tax due as shown on NTL XXXXX and the tax shown on the underlying audit correction.

An evidentiary hearing was held on February 6, 1997 after which both parties filed briefs.

My recommendation is that the tax due on NTL XXXXX be reduced to the amount shown on the underlying audit correction, and as so reduced, that it and NTL XXXXX-A be made final.

Findings of Fact:

1. Taxpayer is engaged in operating a grocery store, selling food and general merchandise. Tr. p. 7.

2. Taxpayer's grocery store is located in Illinois. Tr. p. 18.

3. During January of 1994, the Department began auditing the taxpayer's sales tax returns for the period January 1991 through December 1993. Tr. p. 17.

4. In the early stages of the audit, taxpayer executed a power of attorney authorizing its accountant, JOHN DOE ("DOE"), to represent it in connection with this audit. Tr. p. 19.

5. DOE told the Department's auditor that the taxpayer's books and records were on his computer and because of computer problems he could not provide the auditor with the books and records she requested. Tr. p. 20.

6. There were no hard copies of taxpayer's books and records available to the auditor. *Id*

7. Because no books or records were supplied to the auditor, she obtained bank records and federal tax returns and used them to determine unreported sales. *Id.*

8. The information in the federal income tax returns corresponded with the information in the bank records. Tr. p. 21.

9. The deposits that were shown in the bank records provided information for determining the amount of taxpayer's gross receipts during the audit periods. Tr. p. 22.

10. The unreported sales determined by the Department's auditor from the federal income tax returns and bank records exceeded reported sales by \$6 million per year for 1991, 1992, and 1993. *Id.*

11. The unreported sales determined by the auditor were several times reported sales for each year. *Id.*

12. The auditor apportioned the unreported sales between low tax rate items and high tax rate items using the relative percentages of each category of sales as reflected on the sales tax returns that the taxpayer filed for the years at issue. Tr. p. 29.

13. For 1991, the Department's auditor apportioned 17.77% of sales to sales of high rate items and 82.23% to low rate items. *Id.*

14. For 1992, the Department's auditor apportioned 18.97% to high rate items and 81.03% of sales to sales of low rate items. *Id.*

15. For 1993, the Department's auditor apportioned 13.25% to high rate items and 86.75% of sales to sales of low rate items. *Id.*

16. These percentages were in the range of low rate sales *vis a vis* high rate sales reported to the Department by other grocery stores. Tr. pp. 40, 49.

17. The Department's auditor also disallowed the deductions taxpayer claimed for tax exempt sales including sales for food stamps because taxpayer provided no verification of the amounts claimed. Tr. pp. 47, 48.

18. The taxpayer refused to obtain verification from the Department of Agriculture of the amount of food stamps taxpayer redeemed during the periods under audit when the Department's auditor requested that he do so. Tr. pp. 48, 49.

19. There is a difference of \$102,051 between the amount of tax due as shown on the NTL for the period January 1, 1991 through November 30, 1993 (\$755,078) and the amount shown on the Department's Form SC-10—G Audit Correction and/or Determination of Tax Due (prior to 12/93) (\$653,027). Dept. Exs. No. 1, 3, respectively.

20. The Department's auditor could not explain the discrepancy between the amounts of tax due as shown on the NTL and the Form SC-10-G. Tr. p. 16.

Conclusions of Law

Under Section 4 of the Retailers' Occupation Tax Act (35 ILCS 120/4), a corrected return of the Department is *prima facie* evidence of the correctness of the amount of tax due and the Department's *prima facie* case is established by submitting the corrected return into evidence at the hearing. Elkay Manufacturing Co., v. Sweet, 202 Ill.App.3d 466, (1st Dist. 1990). After considering the evidence and testimony presented at the hearing in this matter, I find that the taxpayer has failed to overcome the Department's *prima facie* case and that Department's determination of gross sales and the proportion of sales of high tax rate items *vis-à-vis* low tax rate items was reasonable.

Furthermore, the Department's disallowance of deductions claimed by the taxpayer was proper.

Issue No. 1

The first issue specified in the pre-trial order is whether the Department's auditor applied the correct high/low percentage to items sold by the taxpayer. The taxpayer argues that the Department erred in using the percentages reported by the taxpayer on the tax returns it filed for the audit periods.

Under the applicable statutory provision and case law, the Department's determination will stand if it meets a minimum standard of reasonableness. Masini v. Dept. of Revenue, 60 Ill.App.3d 11 (1st Dist. 1978). Accordingly, if the percentages used by the Department's auditor were reasonable, the Department's *prima facie* case will stand.

The statute requires a taxpayer engaged in the business of selling tangible personal property at retail to keep books and records accurately recording sales of tangible personal property at retail, among other things. 35 ILCS 120/7. When a taxpayer fails to supply the Department with records to substantiate its gross receipts, the Department is justified in using other reasonable methods to estimate the taxpayer's gross receipts, and, in doing so, the Department is required only to meet a minimum standard of reasonableness. Mel-Park Drugs, Inc. v. Department of Revenue, 218 Ill.App.3d 203 (1st Dist. 1991). In this case, the Department's auditor was provided with no records by the taxpayer's representative. For that reason, she obtained federal income tax returns and bank records to determine the amounts of taxpayer's gross receipts during the audit periods.

To apportion the gross receipts between high tax rate sales and low tax rate sales, the auditor compared the percentages of each that the taxpayer reported for the audit periods with the percentages reported to the Department by other grocery companies. Finding that the percentages reported by the taxpayer were within the range reported by the other grocery companies, she used the percentages reported by the taxpayer.

The statute does not require the Department to substantiate the basis for the corrected return. When the Department's methodology is challenged, the only question is whether it meets some minimum standard of reasonableness. Masini v. Department of Revenue, *supra*. In this case, because the taxpayer failed to provide the auditor with books and records, she used federal income tax returns and bank records to determine gross receipts. Since gross receipts reported on the taxpayer's federal income tax returns were consistent with its bank deposits and no other information regarding actual gross receipts during the audit period was available to the auditor, her method of determining gross receipts met the required minimal standard of reasonableness.

To apportion gross receipts between high tax rate and low tax rate sales, the auditor used the percentages that the taxpayer had reported on the tax returns it filed with the Department for the audit periods. Because the percentages reported by the taxpayer were consistent with the percentages reported by other grocery store companies, the auditor's use of the rates of apportionment reported by the taxpayer also met a minimal standard of reasonableness.

Taxpayer argues in its brief that the Department should not have used the apportionment percentages for high and low tax sales which were reported by the taxpayer on the tax returns it filed for the audit periods because those returns contained

admittedly inaccurate and fraudulent figures. However, taxpayer introduced no evidence to prove that the factors it reported during the audit periods were incorrect. Rather, the taxpayer argues, the Department should have used the factors determined for the months of April through July of 1994, a period during which the taxpayer had retained a new accountant and was allegedly reporting accurate information to the Department. However, there is no evidence in the record to show that the apportionment percentages for months following the audit periods were the same as or representative of the audit periods, or that they would have been more accurate than what the taxpayer reported on the returns it filed for the audit periods. The proportion of taxpayer's sales of high rate items to low rate items in periods after the audit period is simply not relevant to the issue of whether the Department's apportionment of gross receipts between high and low tax rate sales for the audit periods was reasonable.

Therefore, for the reasons set forth above, I conclude that the Department's method of determining gross sales and the apportionment between high rate sales and low rate sales meets a minimal standard of reasonableness.

Issue No. 2

The second issue specified in the pre-trial order is whether the auditor improperly disallowed certain deductions taken by the taxpayer. Taxpayer produced no documentation in support of the deductions claimed on its tax returns. When the auditor asked DOE to confirm food stamp redemptions with the Department of Agriculture, which he could have done, he refused. Taxpayer argues in its brief that the auditor should have used food stamp redemption figures calculated for reporting periods in 1994.

These periods were subsequent to the audit periods, however, and are not relevant to activity during the audit periods.

The statute is very clear in requiring a taxpayer to maintain documentation supporting any deductions claimed on its tax returns. 35 ILCS 120/7. In this case, the taxpayer produced no records in support of its claimed deductions and refused to request confirmation of food stamp redemptions from the Department of Agriculture. Taxpayer's argument that the auditor should have used figures calculated for periods in 1994 after the audit period is specious. Those numbers are not relevant to the periods at issue. Therefore, the auditor's disallowance of the deductions claimed is proper.

Issue No. 3

The final issue is not mentioned in the pre-trial order. However, it must be taken into account in this matter. The amount of tax due as shown on NTL XXXXX (\$755,078) exceeds the amount shown on the Department's Form SC-10—G Audit Correction and/or Determination of Tax Due (prior to 12/93) (\$653,027). Dept. Exs. No. 1, 3. There is nothing in the record to explain this discrepancy. Under the statute, the Department's *prima facie* case is made when the Department's corrected returns are entered into evidence. 35 ILCS 120/4. Accordingly, the amount of tax assessed on NTL XXXXX must be reduced to the amount shown on the Department's Form SC-10—G.

For all of the reasons set forth above, I have concluded that the Department prepared the audit corrections to taxpayer's returns in a reasonable manner according to its best judgment and information, and that the taxpayer failed to overcome the Department's *prima facie* case.

WHEREFORE, for the reasons set forth above, I recommend that the amount of tax due on NTL XXXXX be reduced to \$653,027, that penalties and interest be recalculated accordingly, and, as so recalculated, that it be made final. I also recommend that NTL XXXXX-A for the month of December 1993 be made final.

November 25, 1997

ENTER:

Administrative Law Judge